Henshaw & Vierra Management Counsel, L.L.C.

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Shields Up!

The current unpleasantness in the credit markets is neither new nor something to be neglected. It has happened before. It will happen again. And, it will affect your service bureau.

The other day I was with a 30 year old at an investment meeting and he said “this is the worst credit market in my lifetime.” My lifetime is longer. I have seen this happen in 1974, 1981, 1987, 1992, and 2001. No, I was not here in 1907, 1920, or from 1929 to 1938! Each time the crisis began due to a different circumstance. Each time it did “spill over into the general economy”. Each time it was about greed, panic, and trust.

A Little Background

In 2007 it too is about greed, panic, and trust. Since the mid 1970’s the mortgage business has been changing. Prior to that time a home loan was made by a local lender who knew the property, knew the borrower, and kept the loan as an investment. If a property or borrower got in trouble, the lender knew it and acted to protect their interest. If lots of properties and borrowers got in trouble, the lender may well have gone bankrupt to the detriment of all. So in the ‘70’s borrowing became institutionalized. Lenders became national then international. Investment bankers, who are “wicked smart don’t you know”, replaced local bankers. They began to rely on volume driven, commission paid mortgage brokers to generate loans. They “convinced” rating agencies that the simple to esoteric mortgages that they created were credit-worthy since they were making a market in these instruments and even smarter buyers – hedge fund managers, pension funds and money market fund managers – were trading in them. Everyone was happy. Everyone was making more money than that old local lender could have dreamed of!

What was wrong with this picture? Well, greed overwhelmed prudence, panic swamped “wicked smart”, and trust blew away on the winds of change. The investment bankers did change the world. Their process and new instruments did bring huge amounts of funds to the housing markets. They were able to transfer risk to people and institutions who were willing to take more risk. What they did not do was care about monitoring what they created. When the US Central Bank lowered interest rates to stimulate the economy after the “Dot.com” collapse, margins expanded, fees and profits were huge, and greed overwhelmed care and prudence. Loan underwriting seemed to have stopped. The rating agencies were caught putting the stamp of approval on their “clients” (the investment banks) latest clever instruments. Buyers of these instruments had long ago, if ever, stopped trying to understand what they were buying.

About August of last year cracks began to appear. The US Central Bank was raising interest rates to “fight inflation”. Home “buyers” on the margin were finding that the teaser rates used to get them into their loans were resetting at rates they could not afford. Delinquencies and foreclosures, which were at 100 year lows rose to 50 year lows, but the TV hacks could yell that rates were up 100%. During the winter, the facts began to come clear. Marginal loans had been made and securitized and sold to investors around the world which had been poorly underwritten. Fraud may have been committed! The investment bankers and the US Central Bank did what you would expect. They said that it was a limited problem, which would not spread to other markets. Hedge funds and investment bankers moved to get out the side doors, only to find that not only would investors not buy their products, they wanted their money back. The markets froze. There was no liquidity. The French banks stopped lending to each other! In a flash, the lack of trust in the mortgage market moved to the commercial paper markets, and most other money markets. Central banks around the world moved to provide liquidity to the markets. But they will need to remove the bad credits from the market and come down harshly on the brokers, bankers, rating agencies, and fund managers who abused the system to fully restore trust. We have yet to see that step, but it will come this winter.

Shields Up! (cont.)

What does all this mean for your payroll service bureau?

You will see a recession over the next four to six quarters. This will mean fewer employees at your customers' business. This could mean that some of your customers will be financially weaker, and you will need to have your deposit systems and processes up to date and functioning at a high level to provide a good service and protect yourself from credit losses. Enforce your NSF policies! Think about doing credit checks on your customers, with their permission, of course. Carefully examine where you put temporary fiduciary funds to ensure their safety and timely availability to make payments on behalf of your customers. Do your homework on the money market funds you use, and the repo's and commercial paper you buy. As trust is restored in the system, I image that US Treasury paper will be the first to trade freely again, then US Agencies, then direct obligations (not derivatives, options, puts, calls, etc.) of strong corporations (large and small), then bank deposits, and on down the line. The rates on the best paper will fall as the crowd races to dump money on them. Rates for the next tier, may or may not change a lot from where they are now. The high risk paper may find no market at all. Please don't be tempted by high rates on credits you do not understand. Liquidity is your greatest responsibility to your customers. Here endeth the lesson!

On Building Value and Valuation

Lots of times, clients of ours don't think about the value of their company until they need a valuation because they have an estate issue, someone offers them a number for their company, or they want to sell their bureau. We then get called in to help them think through a valuation and consult with them through the closing. The payroll service bureau business is unique in that several good, capable buyers are usually looking to buy customer lists. In addition, other buyers come into the market to buy bureaus for various reasons, and use various valuation techniques to come up with their purchase offers.

Common elements of valuation are total revenues, number of billable customers, pricing strategies used to build the customer base, and seller (as well as buyer) attrition rate considerations. You can go to our website www.henshawvierra.com and review the presentation "Payroll Service Bureau Benchmarking" to see how members of the IPPA are doing with these common elements.

We strongly believe that you need to plan ahead to build value in your service bureau to ensure that you can get the very best valuation for your service bureau.

The great attributes of your business are that: it is a core business service for all businesses, it lends itself to economies of scale and can be "outsourced", it is a cash business, and it is a business which lends itself to simple financial analysis (look at our website article "Consideration for Managing a Service Bureau").

Building value happens over time. It is made up of: good business planning, using a budget to guide your business, defining and sticking to a particular marketing strategy, building and using a process and system of controls to manage customer accounts and deposits, and service bureau risk. We can help you. If you take the time to build value, you will get a strong valuation when the time comes.

Henshaw/Vierra Management Counsel, LLC

Henshaw/Vierra was founded to help the owners of family held companies and their managers build value.

We work with owners and their key staff to: develop a business plan; evaluate operating systems; organize system conversions; and define the control environment within the service bureau.

We work with owners to: develop plans for succession, and represent owners in growing and/or selling their company.

We can help owners build better bureaus.

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